

REPORT BY THE  
AUDITOR GENERAL  
OF CALIFORNIA

---

**A REVIEW OF THE LOS ANGELES  
CITY HARBOR DEPARTMENT**

---

REPORT BY THE  
OFFICE OF THE AUDITOR GENERAL

P-545

A REVIEW OF THE  
LOS ANGELES CITY HARBOR DEPARTMENT

APRIL 1986



Telephone:  
(916) 445-0255

STATE OF CALIFORNIA  
**Office of the Auditor General**

660 J STREET, SUITE 300  
SACRAMENTO, CA 95814

Thomas W. Hayes  
Auditor General

April 10, 1986

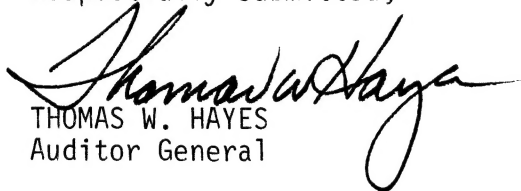
P-545

Honorable Art Agnos, Chairman  
Members, Joint Legislative  
Audit Committee  
State Capitol, Room 3151  
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the Los Angeles City Harbor Department's administration of lease agreements and payments for fire protection services. The report shows that the harbor department does not consistently calculate rates of return from leasing its assets. In addition, the City of Los Angeles overcharged the harbor department in fiscal year 1984-85 for fire protection services.

Respectfully submitted,

  
THOMAS W. HAYES  
Auditor General

## TABLE OF CONTENTS

	<u>Page</u>
<b>SUMMARY</b>	i
<b>INTRODUCTION</b>	1
<b>ANALYSIS</b>	
I    THE LOS ANGELES CITY HARBOR DEPARTMENT DOES NOT CONSISTENTLY FOLLOW THE BOARD OF HARBOR COMMISSIONERS' POLICY ON RATES OF RETURN	5
CONCLUSION	14
RECOMMENDATION	14
II   THE CITY OF LOS ANGELES OVERCHARGED THE LOS ANGELES CITY HARBOR DEPARTMENT FOR FIRE PROTECTION SERVICES	15
CONCLUSION	18
RECOMMENDATION	19
<b>APPENDIX</b>	
THE HARBOR DEPARTMENT'S LEASING PROCESS	21
<b>RESPONSE TO THE AUDITOR GENERAL'S REPORT</b>	
Los Angeles City Harbor Department	25

## SUMMARY

The City of Los Angeles Harbor Department (harbor department) is not reporting to the Board of Harbor Commissioners (board) complete information specifying the harbor department's rates of return from leasing its assets. In some instances, the rates of return are overstated. In other instances, the rates of return are based on asset values that may be less than fair market value.

The Los Angeles City Charter requires the city fire department to provide fire protection services to the harbor area. However, the city considers fire protection services provided to independent city departments to be "special services" and requires the fire department to bill the harbor department and other independent city departments for any fire protection services they receive. According to a 1986 Legislative Counsel opinion, the harbor department may pay the city for special services.

In fiscal year 1984-85, the City of Los Angeles (city) overcharged the harbor department by at least \$182,000 for fire protection services because the fire department's bill to the harbor department was not determined in accordance with city guidelines.

### The Department's Lease Agreements

The harbor department develops with its tenants lease agreements that specify the effective dates of the lease and the tenants' payments for the use of departmental assets such as land, wharves, and buildings. Generally, the harbor department's agreements must be approved by the board before they become effective. The board annually adopts a rate of return percentage that the harbor department should seek to achieve from leasing its assets. In fiscal year 1984-85, the board's adopted rate of return was 10 percent on the fair market value of its assets.

However, the harbor department is not consistently following the board's rate of return policies. In some instances, the harbor department does not use the fair market value of assets for determining the rates of return it reports to the board. For example, in some lease agreements granting tenants the use of department wharves and buildings, the harbor department's staff used asset values that were less than the fair market value of these assets in determining the harbor department's rate of return. In other instances, the harbor department could not demonstrate that the asset values it used to determine rates of return reflected fair market value. For example, in some lease agreements involving land rentals, the harbor department reported to the board a 10 percent rate of return but could not demonstrate how it determined the land values upon which the rate of return was based.

Moreover, an independent appraisal in 1984 of two land properties in the harbor area and statements by the Assistant Director of the harbor department's Property Management Division indicate that the harbor department's standard land values for fiscal year 1984-85 of \$8.50 per square foot for waterfront land and \$7.50 per square foot for land not near the water may have been less than fair market values. As a result, the rates of return on leased lands the harbor department reported to the board could have been overstated, giving the board incomplete information upon which to base its land lease approval decisions.

#### Fire Protection Services

The Los Angeles City Charter requires the city fire department to provide fire protection services to the harbor area. However, the city considers fire protection services provided to independent city departments to be "special services" and requires the fire department to bill the harbor department and other independent city departments

for any fire protection services they receive. According to a 1986 Legislative Counsel opinion, the harbor department may pay the city for special services.

The city administrative officer has developed guidelines for the fire department to follow when determining the charges for special services. However, the fire department overcharged the harbor department by approximately \$182,000 because the fire department did not follow these guidelines in preparing the harbor department's bill.

## INTRODUCTION

The City of Los Angeles Harbor Department (harbor department) is a financially independent department within the City of Los Angeles (city) and is responsible for the daily operations of the Port of Los Angeles (port). The harbor department operates the port under the direction of the Board of Harbor Commissioners (board), which consists of five commissioners appointed by the mayor and approved by the city council. The board is responsible for approving all of the harbor department's major leases and contracts.

Included in the port properties controlled by the harbor department are tidelands and submerged lands granted to the city by the State in 1911. In accordance with Chapter 656, Statutes of 1911, as amended, these lands were granted to the city in trust for the benefit of the people of the State for, among other purposes, commerce, navigation, and fishing.

The harbor department is essentially a landlord and leases to its tenants land, water, and facilities such as wharves, buildings, and cranes. The harbor department's tenants include shipping lines, shipyards, marinas, and restaurants, as well as agencies of the city, state, and federal governments. Revenue from the harbor department's leasing activities is the harbor department's major source of income. The harbor department is financially self-sufficient, and no part of its income is derived from taxes. For the fiscal year ended



June 30, 1985, the harbor department reported net income of \$48,747,000 and total assets of \$691,804,000.

#### SCOPE AND METHODOLOGY

The purpose of our review was to determine if the harbor department properly uses its revenues in financial transactions with the city and if the harbor department consistently applies policies and procedures to reasonably develop its lease agreements.

To determine the propriety of the harbor department's financial transactions with the city, we reviewed its participation in the city's pooled investment program and its payments to the city for fire protection services. In our review of the harbor department's payments to the city for fire protection services, we analyzed the data used by the city fire department to calculate the harbor department's costs for these services, and we analyzed data related to tax payments by the harbor department's tenants.

To review the harbor department's lease agreements, we reviewed the board's policies concerning these agreements and used these policies to analyze a random sample of the lease agreements that became effective in fiscal year 1984-85. Our review tested the harbor department's analysis and development of lease agreements for reasonableness and for conformity with the board's policies.

Our review of the harbor department's participation in the city's pooled investment program included analysis of data from the city Treasurer's Office and the city Controller's Office. We verified that the harbor department received its proportionate share of interest income in fiscal year 1984-85 from participating in the pooled investment program.

We also reviewed the harbor department's installment sale of four cranes to one of its tenants to verify the harbor department's compliance with the board's policies and applicable laws. Our review of the installment sale was based on analysis of the financing and security agreement between the harbor department and the tenant and relevant city and state laws. We determined that the terms of the installment sale guaranteed the harbor department a rate of return of at least 12.8 percent on its investment in the sale, 2.8 percent more than the board's adopted rate of return of 10 percent for fiscal year 1984-85.

## ANALYSIS

### I

#### THE LOS ANGELES CITY HARBOR DEPARTMENT DOES NOT CONSISTENTLY FOLLOW THE BOARD OF HARBOR COMMISSIONERS' POLICY ON RATES OF RETURN

In determining its tenants' rents and its rate of return for leasing assets, the City of Los Angeles Harbor Department (harbor department) does not consistently follow the Board of Harbor Commissioner's (board) policy of using assets' fair market value. In some instances, the department uses asset values that are lower than the fair market value of the assets. In other instances, the department uses asset values that its staff cannot demonstrate reflect fair market value. As a result, the rates of return the harbor department reports for leasing its assets are sometimes overstated or do not provide the board with meaningful information upon which to base its decisions. Consequently, the board does not have sufficient information to ensure that the harbor department is making the most effective use of its assets.

#### The Department Does Not Always Clearly State or Document Its Rates of Return

The harbor department leases many different types of assets to its tenants, including land, water, wharves, cranes, and buildings. The lease agreements specify the length of time the tenants may use the

assets and the tenants' rent to the department for the use of these assets. (See the appendix for a discussion of the department's leasing process.)

Although the board's rate of return policy specifies that the harbor department should base a tenant's rental payments on the fair market value of the assets the tenant is leasing, the harbor department sometimes uses asset values below fair market values when determining a tenant's rental payments and the harbor department's rate of return. Consequently, the rates of return reported by the harbor department are sometimes overstated. In addition, the standard market values that the harbor department uses for determining land rental rates may be below the current market value. Thus, the harbor department's rate of return from land rentals may be correspondingly overstated. As a result, the harbor department is not providing the board with the information it needs to ensure that the harbor department is making the most effective use of its assets.

We reviewed a random sample of 27 (22 percent) of 124 lease agreements or amendments to agreements between the harbor department and its tenants. The 27 agreements, which became effective in fiscal year 1984-85, included 41 departmental assets, of which 24 were land assets and 17 were facilities such as wharves and buildings.

### The Department's Rentals of Facilities

In 13 of the 27 lease agreements we reviewed, the harbor department leased 17 assets, including wharves, buildings, and warehouses. The harbor department reported to the board that the rental rates for 6 of the 17 assets were based upon the amortization of the assets' book values and improvement costs over a 20-year period at a 10 percent interest rate. (Book value is the original cost of an asset minus any accumulated depreciation on the asset.) This 10 percent interest rate was equivalent to the board's adopted rate of return of 10 percent for fiscal year 1984-85. The six assets, which included wharves and buildings, were included in three related agreements in our sample.

Furthermore, the harbor department used the book value method to develop an additional nine agreements that were not in our sample. However, the reproduction cost method of valuing the assets would have better reflected the fair market value of the buildings and wharves. Reproduction cost is the estimated cost of constructing or acquiring an asset at current prices. According to a study prepared for the Maritime Administration of the U.S. Department of Transportation, reproduction cost, which is almost always higher than an asset's book value, is a more accurate reflection of the fair market value of an asset than is the book value of an asset. The Director of the Property Management Division told us that the harbor department does not normally use book value in establishing a rate of return. However, the

Assistant Director of the Property Management Division indicated that he used the book values of the wharves and buildings because these asset values yielded an "achievable rental rate."

Using an estimated reproduction cost of the wharves and buildings calculated by the Assistant Director of the Property Management Division, we recalculated the harbor department's rates of return for leasing the wharves and buildings in the 12 agreements and determined the harbor department's rate of return would be approximately 6 percent for each of the 12 agreements. Because the department reported a 10 percent rate of return to the board when a more reasonable estimate of the rate of return was closer to 6 percent, the board did not have complete information upon which to base its approval of the 12 agreements.

The harbor department's rental rates for 9 of the 17 assets were based on the harbor department's tariff schedule or on competitive rental rates received by other landlords. For those assets in which the tenants' payments are based on the tariff or competitive rental rates, the harbor department does not routinely report to the board the fair market value or the harbor department's rate of return. According to the Assistant Director of the Property Management Division, the harbor department's staff do not routinely calculate rates of return for these assets because properties in the harbor area have limited uses and staff know whether specific assets are yielding a reasonable rate of return. While we agree that some of these assets, such as

wharves and cranes, have limited uses, we conclude that because the harbor department does not always estimate and report to the board the fair market values and department's rate of return for these assets, the board does not have complete information to ensure that the harbor department is making the most effective use of its assets. The harbor department processed the remaining two assets appropriately.

#### The Department's Rentals of Land

In 19 of the 24 agreements involving land rental, the harbor department's documents indicated that its rate of return on the rented land was equal to the board's adopted rate of 10 percent. Further, the harbor department reported that the rates of return were based on land values ranging from \$6.00 to \$8.50 per square foot for waterfront property and from \$2.60 to \$7.50 per square foot for property that was not on the waterfront. We could not verify the land values or the harbor department's rate of return in these 19 agreements because the harbor department's staff do not always document how they determine the value of land leased to tenants.

According to the harbor department's Assistant Director of the Property Management Division, most of the harbor department's determinations of land rental rates are not easily documentable. The assistant director also told us that the Property Management Division periodically determines the standard values of land the harbor department controls. These land values are based upon the Property

Management Division staff's knowledge of real estate activity in the harbor area, recent purchase prices of land acquired by the harbor department, and recent appraisals of land values in the harbor area. The harbor department uses standard values so that tenants pay similar rates for the use of similar land. The assistant director also indicated that market values for land in the harbor area have increased dramatically in the last five years. In some cases, the land values have more than tripled. Due to the rapid escalation in land values over such a short period of time, the harbor department deemed it impractical to immediately increase tenants' land rental rates to reflect the increased land values. Instead, the harbor department decided to gradually increase land rental rates based on increased land values until the rental rates accurately reflect the land's market value.

The assistant director's statements are supported by an independent appraiser's determination in October 1984 of waterfront land values for two land areas in the harbor area. The independent appraiser's assessment of the waterfront land values is higher than the standard market value the harbor department used for waterfront land in fiscal year 1984-85.

According to the Director of the Property Management Division, the harbor department's standard market values in fiscal year 1984-85 were \$8.50 per square foot for waterfront property and \$7.50 per square foot for property located away from the waterfront. The Property



Management Division's staff could not show us how they determined these values. In addition, considering the assistant director's statements about gradually increasing tenants' land rental rates and the independent appraiser's assessment of waterfront land values for two properties in the harbor area, we conclude that the standard market values of land the harbor department used in fiscal year 1984-85 may have been less than the fair market value of harbor area lands controlled by the harbor department. As a result, the harbor department may have overstated the rates of return on leased lands that it reported to the board, thereby giving the board incomplete information upon which to base its approval of land-leases.

Because the harbor department does not routinely document its determinations of land values, we could determine the land value and rate of return for only 2 of the harbor department's 24 agreements involving land rental. In one agreement, the harbor department based the tenant's lease payments on a percentage of sales by sub-tenant businesses on the leased premises. The five-year agreement also required that the tenant's minimum annual payment to the harbor department would be at least 75 percent of the harbor department's revenues from sub-tenant business sales in the previous year. This agreement included land and water assets, as well as a parking lot. The market value of these assets was determined by an independent appraiser before the harbor department determined the tenant's lease payments. Using the independently assessed value of the assets and the harbor department's minimum annual guarantee, we determined the harbor

department's guaranteed rate of return from this agreement was approximately 4.5 percent in the first year.

One of the lease agreements in our sample has a term of 50 years and represents the harbor department's largest land rental, which involves approximately 148 acres. The harbor department determined the revenues for this agreement from the charges the tenant pays for each cargo container that passes through the tenant's leased premises. During the harbor department's analysis of this agreement, the harbor department contracted with a private consulting firm to estimate the number of cargo containers the tenant would process during the first ten years of the agreement. The harbor department used these estimates and its own estimates of the land values of the premises included in the agreement to determine the anticipated rates of return from the agreement for the first five years.

According to a report signed by the harbor department's chief deputy executive director and submitted to the board, the harbor department did not anticipate achieving an annual 10 percent rate of return on the fair market value of the land included in the project until 1989. The harbor department structured the agreement so that the tenant's payments were relatively low in the first few years of the agreement as an inducement for the tenant to enter the agreement.

Our review of this agreement indicates that the harbor department's rate of return calculations were based on land values that

were approximately one-half the fair market value of the land. We base this conclusion on a memorandum in the agreement file from the Director of the Property Management Division to, among others, the Chief Deputy Executive Director of the Harbor Department and the department's project manager in charge of analyzing this agreement. In this memorandum, the Director of the Property Management Division cites land values for the property included in the agreement that were more than twice the land values used to calculate the rates of return specified in the chief deputy executive director's report. This memorandum was dated before the chief deputy executive director submitted his report to the board.

Using the land values cited in the memorandum from the Director of Property Management Division and the data available to the department staff when they calculated rates of return, we determined the harbor department would not receive a 10 percent rate of return on the value of the land in the agreement until 1994, which is five years later than the year the harbor department reported to the board. Because the harbor department overstated the rates of return to the board, the board did not have complete information upon which to base its approval and to ensure that the harbor department made the best use of the land assets included in the agreement.

## CONCLUSION

The City of Los Angeles Harbor Department is not always providing the Board of Harbor Commissioners with the information it needs to ensure that the department is making the most effective use of its assets. Although the harbor department submits reports to the board explaining its lease agreements, the harbor department does not consistently follow the board's policies for determining the harbor department's rate of return from leasing its assets. In addition, the harbor department may be using understated land values to determine the rate of return from most of its land rentals. Moreover, the harbor department does not calculate rates of return for some of the assets it leases to its tenants.

## RECOMMENDATION

To ensure that the Board of Harbor Commissioners has the information it needs to direct the harbor department toward the most effective use of its assets, the board should require the harbor department to adopt procedures that consistently use the assets' fair market values to calculate rates of return from leasing its assets.

## II

### THE CITY OF LOS ANGELES OVERCHARGED THE LOS ANGELES CITY HARBOR DEPARTMENT FOR FIRE PROTECTION SERVICES

The Los Angeles City Charter requires the city fire department to provide fire protection services to the harbor area. However, the city considers fire protection services provided to independent city departments to be "special services" and requires the fire department to bill the harbor department and other independent city departments for any fire protection services they receive. According to a 1986 Legislative Counsel opinion, the harbor department may pay the city for special services.

In fiscal year 1984-85, the City of Los Angeles (city) overcharged the harbor department by at least \$182,000 for fire protection services because the city's fire department did not follow guidelines for determining the harbor department's costs for services. Of this overpayment, \$136,000 was made because the fire department charged the harbor department for fire boat responses that could not be verified. The remaining \$46,000 was for fire boat responses to property not controlled by the harbor department.

## Fire Protection Services in the Harbor Area

The Los Angeles City Charter mandates the fire department to protect the harbor area. The fire department uses fire trucks and fire boats in the harbor area to carry out this mandate. The city considers fire protection services provided to the harbor department and other independent departments to be "special services" and charges the departments for these services. Special services are defined by the Los Angeles City Administrative Officer as services provided to an identifiable segment of the population or to any of the independent city departments such as the Department of Water and Power, the Department of Airports, or the harbor department. For example, services provided to these departments by the city's Personnel Department or Treasurer's Office are considered special services for which the departments are billed. Similarly, the fire department is required by Mayor Executive Directive Number 12 to bill the harbor department and other independent city departments for any fire protection services they receive.

Annually, the fire department calculates a bill for the harbor department based on services provided in the previous year to the harbor area. To determine how much to bill the harbor department for fire protection service, the fire department calculates the total cost for each fire truck and fire boat and then charges a portion of these costs to the harbor department. This charge is based on the amount of

time fire department units spent responding to calls chargeable to the harbor department compared to the total time the units spent responding to all calls.

According to a 1976 California Attorney General opinion, the Board of Harbor Commissioners (board) is not obligated to reimburse the city for fire protection services. However, according to the opinion, the board may authorize payment to the city for these services. In addition, a 1986 Legislative Counsel opinion concluded that the harbor department may pay the city for special services.

Since fiscal year 1979-80, the board has adopted annual resolutions that authorize the harbor department to pay the city for fire protection services. The department's payments to the city for fire protection services have increased from \$1,433,367 in fiscal year 1979-80 to \$6,200,000 in fiscal year 1984-85. The board's resolutions indicate that it considers the harbor department's payments for fire protection to be necessary expenses. According to the city charter, payment of any necessary department expenses is one of the permissible uses of the harbor department's revenues.

The City Overcharged the Harbor Department  
for Fire Protection Services  
for Fiscal Year 1984-85

In fiscal year 1984-85, the harbor department's staff reviewed fire boat response data but did not find any material discrepancies in

the city's bill to the harbor department. The city's fiscal year 1984-85 bill to the harbor department for fire protection services was \$6,472,765, or \$272,765 more than the harbor department's payment of \$6,200,000. Of the \$6,472,765 bill, \$6,222,544 was for fire boat services and the remainder for fire truck services. We analyzed response data for all fire boats to determine if each fire boat response should have been billed to the harbor department. We based our determinations of which fire boat responses should have been billed to the harbor department on the city administrative officer's guidelines used by the fire department. These guidelines specify which fire department responses in the harbor area should be charged to the harbor department.

We determined that the city overcharged the harbor department at least \$182,000 in fiscal year 1984-85 because the fire department did not follow the city administrative officer's guidelines for calculating charges. Of this amount, \$46,000 was for responses to property the harbor department does not control, and \$136,000 was for fire boat responses we could not verify.

#### CONCLUSION

Although the City of Los Angeles is required to provide fire protection services to the harbor area, the city considers these services to be "special services." The city, therefore, bills the harbor department and other independent departments



for these services. According to a 1986 Legislative Counsel opinion, the harbor department may pay the city for special services.

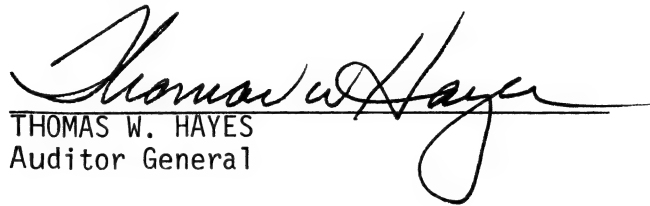
The city overcharged the Los Angeles City Harbor Department for fire protection services in fiscal year 1984-85 by at least \$182,000 because the fire department did not follow the city administrative officer's guidelines for calculating charges.

#### RECOMMENDATION

The Los Angeles City Harbor Department should not pay the city \$182,000 of its remaining fiscal year 1984-85 bill of \$272,765. In addition, the harbor department should continue to annually review fire department response data to verify the accuracy of the fire department's charges to the harbor department.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



THOMAS W. HAYES  
Auditor General

Date: April 7, 1986

Staff: Robert E. Christophel, Audit Manager  
John J. Billington  
Eric R. Robbins

THE HARBOR DEPARTMENT'S LEASING PROCESS

Overview

The Board of Harbor Commissioners (board) has developed a rate of return policy to serve as a guideline for the Los Angeles City Harbor Department's (harbor department) staff to follow in developing and negotiating lease agreements. The board annually adopts a rate of return percentage that the harbor department should try to achieve from leasing its assets to tenants. This rate of return is based on a recommendation from the harbor department and, according to board policy, should reflect prevailing interest rates, alternate investment opportunities, and competitive returns being received by other land owners.

When the harbor department's staff develop a lease agreement or an amendment to an existing agreement, the staff identify the assets included in the agreement and determine the rental rates for the use of the assets. The harbor department's staff determine the rental rate using one of three general methodologies. In the first method, the harbor department bases rental rates upon rates comparable to those charged by other property owners. In the second method, the harbor department uses its tariff schedule, a schedule of rates and charges, for those tenants regulated by the Federal Maritime Commission. In the third method, the harbor department estimates the fair market value of the assets included in the agreement and then uses the board's adopted rate of return to calculate rental rates.

After the harbor department has determined a rental rate, the harbor department's staff negotiate the terms of the lease with the tenant. According to the Director of the Property Management Division, these negotiations and the final terms of the lease are based on competitive market factors. The harbor department prepares a report for the board that explains the terms of the lease agreement, including the assets that are included in the agreement and the tenant's payments for the use of these assets. The harbor department usually states in the report the rate of return it will receive from leasing the assets. The board must approve lease agreements before they can become effective.

Tenant Payments Based on the  
Harbor Department's Tariff Schedule

According to a harbor department traffic rate analyst, the harbor department is required by the Federal Maritime Commission (FMC)

to use the harbor department's tariff schedule to determine tenant payments if the tenant is a "common carrier by water" (common carrier) or an entity that provides common carriers with cargo handling or related services. The harbor department may use rates not in the tariff schedule only if these rates are approved by the FMC. The FMC regulates both the common carriers, which transport passengers and cargo, and the entities that provide them services. The harbor department's tariff schedule specifies rates and charges for many uses of the harbor department's assets, including crane rental, office rental, and the use of the harbor department's wharves for loading or unloading cargo.

According to a traffic rate analyst, the harbor department does not use the board's rate of return policy to develop the rates and charges in the department's tariff schedule. Instead, the rates and charges are based on competitive rates charged by other California ports that are members of the California Association of Port Authorities.

#### Tenant Payments Based on Asset Values

The harbor department estimates the market value of an asset and then uses the board's adopted rate of return to determine rental rates. The harbor department determines the value of assets in several different ways. For example, according to the Assistant Director of the Property Management Division, the harbor department bases the value of land upon the harbor department's cost of purchasing the land or upon recent land appraisals in the harbor area. Values of water areas are based on the uses of the lands adjacent to the water areas. Other assets the department owns, such as buildings and wharves, are valued at the estimated cost of replacing the assets or the initial cost to purchase the assets.

Once the department has determined the value of the assets the tenant is leasing, it uses different methods to determine its rate of return and to calculate rental rates. The harbor department may use the accounting rate of return method, in which the value of the asset a tenant is leasing is multiplied by the annual rate of return desired by the board. For example, if the board's adopted rate of return is 10 percent and the value of an asset a tenant is leasing is \$100,000, the tenant's rent will be \$10,000 per year (\$100,000 multiplied by 10 percent per year).

The harbor department also uses methods based on discounted cash flow analysis to determine rental rates. These methods recognize the time value of money, or the fact that \$1 received and invested today is worth more than \$1 received one year from now. Amortizing the value and any improvement costs of an asset is one method of discounted cash flow analysis that the harbor department uses. To calculate a tenant's payments using this method, the department multiplies the value of an asset by an amortization factor, which amortizes, or spreads, the value of the asset over a specified period of time at a specified interest rate, or rate of return. For example, using the

example above and assuming the asset has an estimated life of 20 years, the tenant's payment would be \$100,000 multiplied by the amortization factor for a 10 percent rate of return over 20 years (0.11746) or \$11,746 per year.

Tom Bradley  
Mayor, City of Los Angeles

**Board of Harbor Commissioners**  
Joseph J. Zaninovich, President  
Dominick W. Rubalcava, Vice President  
Frederic A. Heim  
Jun Mori, Esq.  
E. Grace Payne, LL.D.  
Charles T. Gibson, Secretary

Ezunial Burts  
Executive Director

April 2, 1986

Mr. Thomas W. Hayes  
Auditor General  
State of California  
660 J Street, Suite 300  
Sacramento, California 95814

This is in response to the draft audit report recently sent to Harbor Commission President Zaninovich. He asked me to respond on behalf of the Department.

Staff and the Board of Harbor Commissioners are in the process of reviewing and changing reporting methods, procedures and policies. This was in progress prior to the start of the audit. Your report will be useful in that regard.

You are correct that our methods for evaluating certain leases have varied. We believe the use of a variety of evaluation methods is appropriate. For example, in several leases analyzed the auditor noted we used "book value". This means we received a lower rate of return or charged below standard rents. A reduction in charges was necessary to accommodate the needs of a depressed fishing industry and to promote commerce.

We made every effort to ensure that Commissioners were adequately informed regarding this and the methods used to arrive at the finally reported rate of return percentage. Further, "sound value" as a basis for valuing assets has been discarded for some time and we now utilize a replacement cost new approach in most cases.

Board policy states that valuation of improvements at current market value should be done "whenever practical". At the same time, the policy acknowledges that "transition to market value may take some time and involve a number of interim steps, but market value is the ultimate goal."

The Board's 1982 general policy states that the rate of return is applied to the estimated fair market value of land and water areas.

Mr. Thomas W. Hayes  
Page 2  
April 2, 1986

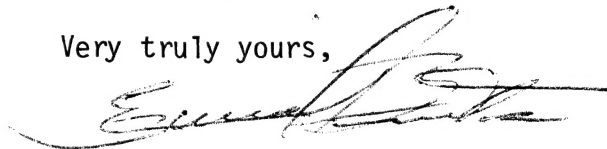
Market values fluctuate, since they are subject to competitive pressures, as well as the physical characteristics of the property. Estimating market value is not an exact science and we acknowledge that the results of estimates are always open to question.

I hope this clarification of policy and its application is useful to you.

It seems important to put the entire operation of the Port of Los Angeles in perspective to others in the nation. We have achieved throughput and financial performance that places us among leaders in the nation. We have experienced increased commerce, navigation and fisheries improvements, while maintaining fiscal self-sufficiency.

Thank you for the opportunity to review and comment on your audit report. Given the limited time to respond, my comments have been brief and general. If there is a need to discuss further the subjects covered in the audit, I would be happy to provide a more detailed and thorough response.

Very truly yours,

A handwritten signature in dark ink, appearing to read 'Ezunial Burts', written over a horizontal line.

EZUNIAL BURTS  
Executive Director

EZ:CTG:dhc  
cc: Mr. Kennedy

cc: Members of the Legislature  
Office of the Governor  
Office of the Lieutenant Governor  
State Controller  
Legislative Analyst  
Assembly Office of Research  
Senate Office of Research  
Assembly Majority/Minority Consultants  
Senate Majority/Minority Consultants  
Capitol Press Corps